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C O N F I D E N T I A L SECTION 01 OF 03 MANAGUA 000373

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TAGS: ECON EFIN ENRG EPET EAID PGOV PREL NU
SUBJECT: NICARAGUA: IMF SIX MONTH REVIEW

REF: A. 07 MANAGUA 2524
¶B. 07 MANAGUA 1771
¶C. 07 MANAGUA 2373
¶D. 07 MANAGUA 2185

Classified By: DCM Richard M. Sanders for reasons 1.4 b & d.

¶1. (C) Summary: On March 7 a visiting IMF review team stated that Nicaragua had performed satisfactorily during the first six months of its Poverty Reduction and Growth Facility (PRGF). Nicaragua met most quantitative and structural targets. General IMF recommendations emphasized improving the investment climate and Nicaraguan competitiveness and increasing capital and anti-poverty expenditures. The IMF team remains concerned about Nicaragua's rising inflation and the lack of transparency surrounding assistance from Venezuela. Both of these issues were on the agenda for the week of follow-up meeting scheduled for March 25. While on the surface things are progressing well in the IMF-GON relationship, tensions remain regarding the government's commitment to the PRGF. End Summary.

Overview on PRGF Performance and Next Steps

¶2. (SBU) At the end of its two week mission (February 25-March 7) the IMF review team, under the direction of new team leader Luis Cubeddu, stated that Nicaragua had performed satisfactorily during the first six months of its PRGF, noting considerable progress on the implementation of the overall economic program. Reserves, fiscal expenditures, and the budget deficit fell within reasonable margins. However, Nicaragua did not meet its targets for real GDP growth, inflation, and the minimum for social spending (Ref B). The IMF team stated that the 2008 National Budget is consistent with the parameters of the program. Nicaragua met all of the structural targets, with the exception of the electricity theft law, which was only passed in general terms in the National Assembly during the visit.

¶3. (SBU) 2007 targets and results and 2008 revised targets are as follows:

2007	Target (Ref B)	Result
Real GDP growth rate	4.2%	3.8%
Inflation	7.5%	16.8%
Deficit (as % of GDP)	1.0%	1.0%
Increase in Reserves (USD)	60 million	160 million
GDP (USD)	5 billion	5.7 billion

2008	Target (Ref B)	Revised Target
Real GDP growth rate	4.5%	4.0%
Inflation	7.0%	10.0%
Deficit (as % of GDP)	1.8%	1.8%
Increase in Reserves (USD)	70 million	70 million
GDP (USD)		6.4 billion

¶4. (SBU) IMF recommendations emphasized improving the investment climate and Nicaraguan competitiveness, increasing capital and anti-poverty expenditures, and hiring a consultant to create a national development plan. Nicaragua has requested an overall revision of program parameters given that the IMF calculated the original PRGF with oil at USD 76 per barrel. The IMF, World Bank (WB), and Inter-American Development Bank (IDB) will continue to work together to help the GON improve financial/fiscal transparency. Pending issues, to have been discussed in Washington meetings the week of March 25, include an anti-inflation program, salary policy, and the renegotiation of local bank bonds (CENIs). The IMF ResRep told us the IMF plans to propose tax reform be part of the next review in six months.

¶5. (U) The IMF Board will vote on the semi-annual review and revised PRGF targets at the end of April. Provided the Board approves the review, the IMF will disburse USD 16 million. Nicaragua already received one disbursement of USD 18.5 million in 2007, as part of the three-year USD 110 million program.

A Message to Donors

¶6. (C) The IMF team expressed concern to the Budget Support Group donors (BSG), who will provide USD 100 million in direct budget support in 2008, regarding the delay in disbursement of funds. Most donors planned on third and fourth quarter disbursements; dependent on the results of their semi-annual review of the GON's performance. The IMF team believes that the delayed disbursements limit the GON's ability to engage in financial planning and effective fiscal management. According to the IMF, if Venezuela fills the financing gap, donors will find they have lost influence with the GON. The IDB and WB offered to look at moving up their disbursement schedules.

Inflation is the Central Issue

¶7. (C) The principal item on the agenda is the steep increase in Nicaragua's inflation; over twice the PRGF target for ¶2007. The IMF team agrees with GON analysis that the principal causes were the supply shocks of world oil prices, high international food commodity prices, and the rise in domestic food prices due to the Pacific coast floods (Ref A). However, the IMF calculated that starting in November 2007, core inflation (excluding food and energy) rose 8%, indicating that there are demand components to this inflation. This problem continues as annualized core inflation in January was 11.6% and rose to 13% in February. (Note: Post will report more fully on Nicaragua's inflation septel. End Note.)

¶8. (C) The IMF strongly recommends the GON immediately implement an anti-inflation program which combines monetary, fiscal and salary policies that can reduce inflation back to the 8-10% range. Key elements will be for the GON to manage expectations, control demand, and establish a clear salary policy which limits further increases.

¶9. (C) The Nicaraguan Central Bank (BCN) promised it would announce an anti-inflation program as part of an overall anti-corruption program; however, the IMF is not optimistic that a program will take place soon. (Note: The BCN did not clarify how they would relate inflation to anti-corruption. End note.) In fact, policy decisions in the last 12 months have been expansionary: a 33% increase in the minimum wage

and a 14% salary increase for government employees in the 2008 budget. Also worrisome is the GON's stated desire to take full advantage of the PRGF allowance for an increase in the deficit by 2% of GDP for social spending using Venezuelan assistance funds.

Venezuela Assistance: What, Where, and How) For Now
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¶10. (C) One of the largest unknown factors in any discussion of Nicaragua's economy and its inflation is Venezuelan assistance. The PRGF assumed that the GON would funnel most of the funds through the public sector. The IMF's review of the books of the companies handling the funds, facilitated by the GON, revealed that the GON is actually processing the funds through private and quasi-private companies. The IMF estimates that Venezuelan assistance (in cash and in-kind) in 2007 was USD 202 million or 3.5% of GDP. Of this, the oil import scheme represented USD 91 million or 1.6% of GDP. The estimates for 2008 are total assistance of USD 515 million, or 8% of GDP. Income from the oil import scheme will be USD 279 million, or 4.4% of GDP. From what the IMF was able to determine, in 2007 the Venezuelan assistance included items such as subsidized fuel for state owned electricity generating plants, hurricane relief, subsidies for public transportation, and grants to the Ministry of Health and the Army, among others. Use of 2008 funds remains unclear, however, complicating the IMF's ability to determine whether the Nicaraguan economy can absorb these funds effectively. To capture more data about Venezuelan assistance, the IMF plans to ask for semi-annual reports on donor assistance, including assistance to the private sector.

¶11. (C) Most worrisome for IMF ResRep Humberto Arbulu Neira is that no one in the GON seems to have a clear grasp of the scope of what Venezuela is doing in Nicaragua. He told the Ambassador on March 17 that when the IMF team presented its data to high ranking GON members, the response was "That is wrong. That is too much." When asked for the GON's consolidated figures on Venezuelan assistance, no one could provide them. Arbulu is also puzzled by the complete disregard on part of the Minister of Finance for the potential role these financial inflows are having on Nicaragua's economy and inflation. The Minister told Arbulu, "It is not my concern. Show me the economic model which demonstrates that assistance can have inflationary and distorting effects."

¶12. (C) During a March 4 conversation with WHA/CEN Director Feeley, BCN President Antenor Rosales was also unconcerned about the effects of Venezuelan assistance, as long as it finances production, particularly agricultural production. According to Rosales, he has successfully argued to President Ortega that Venezuelan assistance could not be in the form of new loans as it would risk the terms of Nicaragua's benefits under HIPC. He concluded the discussion by admitting that the issue is "very political;" a tacit acknowledgment that inflationary effects of Venezuelan assistance may take a back seat to Ortega-Chavez political goals.

Pending Issue in Energy Sector

¶13. (SBU) The PRGF laid out two main energy objectives in 2007/2008, passage of an electricity theft law and a technical audit of electricity distributor Union Fenosa. Colombian consulting firm ConCol will complete the audit of Spanish-owned Union Fenosa's infrastructure investments and technical losses in July. The National Assembly passed the electricity theft law "in principle" on March 12, after the IMF tied its passage to further disbursement of funds to the GON. Starting on March 27, the National Assembly began to review and approve the bill article by article. The bill has been controversial because leftist legislators see it as favoring Union Fenosa at the cost of the consumers. The bill lays out fines (up to 1,000 times the minimum wage) and jail time (six months to five years) for electricity theft and fraud and focuses on consumers of more than 500 KW a month.

Implementing the law will remain a challenge as it depends upon the publication of Nicaragua's new Penal Code. The Ortega government has held up formally publishing the new Penal Code for political reasons, although it claims it is a lack of money (Ref C).

Domestic Debt Also an Area of Concern

¶14. (C) The IMF team is concerned that Nicaragua's overall debt profile remains high because of its excessive domestic debt load. In 2007 Nicaragua's internal debt was USD 1.1 billion, 19.7% of GDP (Ref C). Two-thirds of the domestic debt is bonds issued to compensate property owners, including U.S. citizens, who had their property confiscated in the 1980s. Most of the remainder are bank bonds, bonds issued to refinance the CENIs bonds originally issued to bail out four collapsing banks between 1999-2001. The bank bonds represent less than 25% of domestic debt load and servicing in 2007 totaled 0.5% of GDP. Because the bank bonds are politically unpopular (Ref D), however, they have been the GON's chosen target for refinancing. The political frenzy surrounding the bonds has led to the offices of the Attorney General and Comptroller General (equivalent to the GAO) to join the Ministry of Finance and BCN in negotiating with the banks holding the bonds. The IMF team is very concerned that the banks have not had a choice on the refinancing and has emphasized to the GON that the final agreement must be negotiated in a transparent and voluntary fashion. The IMF is also trying to dissuade the GON from using the money saved from the refinancing to increase salaries for state employees; suggesting they be added to reserves instead.

Comment

¶15. (C) While on the surface things are progressing well in the IMF-GON relationship, tensions remain regarding the government's commitment to the PRGF. Many donors, including the IMF, are concerned that Ortega is only interested in the PRGF as a tool to keep donors in country. He, and many of his closest economic advisors, believe that the PRGF objectives of economic stability are subordinate to political goals. As long as the PRGF serves the GON's political objectives, the GON will take the actions required to abide by the terms of the agreement. If it becomes politically necessary, however, the GON will quickly drop the program.
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